**DEPARTMENT OF STATE REVENUE**

**LETTER OF FINDINGS AND
EXPLANATION OF ORDER DENYING REFUND
NUMBER 05-0191P**

**TAX ADMINISTRATION—NEGLIGENCE PENALTIES FOR USE TAX AUDIT DEFICIENCIES INCURRED FOR THE REPORTING PERIODS COVERING CALENDAR YEARS 2001-02**

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## ISSUES

### I. Tax Administration—Negligence Penalties—Audit Deficiencies—Absence of Willful Neglect—Existence of Tax Accrual System

Authority: I.R.C. (26 U.S.C.) §§ 6651(a) and 6656(a) (1976) (current respective versions at *id.* (2000); IC §§ 6-8.1-1-1, -5-1(b) and (e), -9-1(b) and -10-2.1 (2004); *United States v. Boyle*, 469 U.S. 241, 245 (1985); *Brownsburg Area Patrons Affecting Change v. Baldwin*, 943 F. Supp. 975, 988 (S. D. Ind. 1996), *quoted with approval in* 714 N.E.2d 135, 140 (Ind. 1999), *answering question certified by* 137 F.3d 503, 510 (7th Cir. 1998), *aff'd* 1999 U.S. App. LEXIS 23325 (7th Cir. Sept. 17, 1999); *State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257, 1264 (Ind. 2002); *State v. Sproles*, 672 N.E.2d 1353, 1357 (Ind. 1996); *State ex rel. Matheny v. Probate Ct. of Marion Co.*, 159 N.E.2d 128, 131 (Ind. 1959); *F & F Constr. Co. v. Royal Globe Ins. Co.* 423 N.E.2d 654, 656 (Ind. Ct. App. 1981); *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018, 1024 and 1024-25 (Ind. Tax Ct. 1999); *Ind. Sugars, Inc. v. State Bd. of Tax Comm'rs*, 683 N.E.2d 1383, 1386 (Ind. Tax Ct. 1997); 45 IAC § 15-11-2(b) and (c)(2004)

The taxpayer protests and claims a refund of audit deficiency negligence penalties it paid on the ground that it did not willfully neglect to pay sales or use tax on its purchases because it has a use tax accrual system.

### II. Tax Administration—Order of Conducting Refund Claim Investigations and Audits

Authority: IC §§ 6-8.1-3-1(a), -3-12(a), -4-1(b)(2) and (b)(5), -5-2(a)(2), -9-1(a) (2004); 45 IAC § 15-9-2(c) (2004)

The taxpayer seeks a refund of the negligence penalties on the theory that the Department could have conducted the audit out of which they arose simultaneously with the investigation of an earlier claim for refund that also prompted the audit.

## STATEMENT OF FACTS

The taxpayer is a corporation, chartered and in good standing in Indiana but with its commercial domicile in another state. It was and is engaged in the manufacture of electrical wire for supply to the automotive and home appliance industries. The taxpayer has, and during the years relevant here had, facilities in Indiana. It represented in its protest letters that it had no sales to its customers subject to Indiana gross retail (i.e., sales) tax. However, according to the Department's records the taxpayer has filed consolidated gross retail tax returns (Forms ST-103) since August 1991.

On December 31, 2002, the taxpayer submitted a mid-five figure claim for refund for the four calendar years of 1999-2002 inclusive (hereinafter "the refund claim period" or "the claim period"). The claim was assigned to the Department's Audit Division. It began an investigation of that claim, completing it in September 2003. The Audit Division ultimately issued the taxpayer a low five-figure refund as a result of this investigation, representing approximately half of what the taxpayer had claimed.

Incident to and following the investigation, the Audit Division also began an audit of the taxpayer for possible sales use tax liabilities for calendar years 2001-02 (hereinafter "the audit period"). The field auditor made, and the Audit Division approved, adjustments of the taxpayer's use tax liability for each of those years for purchases of tangible personal property not used in production and on which it had paid neither sales nor use tax. The auditor also recommended, and the Audit Division approved, assessment of a ten percent negligence penalty on each of the deficiencies. The taxpayer promptly paid the proposed assessments in full (including the penalties). It simultaneously protested only the imposition of, and thereafter filed a second claim for refund solely for, the negligence penalties. Additional facts will be provided as needed.

**I. Tax Administration—Negligence Penalties—Audit Deficiencies—Absence of Willful Neglect—Existence of Tax Accrual System**

## DISCUSSION

### A. TAXPAYER'S ARGUMENT

The taxpayer argues that the penalties should be waived and refunded because its neglect was not willful, in that it has a system in place for remitting use tax on taxable purchases of tangible personal property.

## B. ANALYSIS

This document serves as both a Letter of Findings pursuant to IC § 6-8.1-5-1(e) (2004) and "a statement of the reasons for" the denial of the taxpayer's Claim for Refund pursuant to IC § 6-8.1 -9-1(b) (2004). "Both [the protest and refund] remedies may be pursued simultaneously." *State v. Sproles,* 672 N.E.2d 1353, 1357 (Ind. 1996) (alteration added).

IC § 6-8.1-10-2.1 (2004) is the statute that authorizes the Department to impose a penalty for any negligence of a taxpayer in failing to comply with the tax laws that the Department administers. These taxes are listed in IC § 6-8.1-1-1 and include the use tax. IC § 6-8.1-10-2.1(a)(3) states that "(a) [i]f a person: … (3) [i]ncurs, upon examination by the department, a deficiency that is due to *negligence*; … the person is subject to a penalty." *Id.* (Emphasis and alterations added). The amount is set by IC § 6-8.1-10-2.1(b)(4), which states that "(b) [e]xcept as provided in subsection (g) [,] [not in issue here], the penalty described in subsection (a) is ten percent … of:… (4) the amount of deficiency as finally determined by the department[.]" *Id.* (Alterations added.) However, IC § 6-8.1-10-2.1(d) states that "[i]f a person subject to the penalty imposed under this section can show that the failure to…pay the deficiency determined by the department was due to *reasonable cause* and not due to willful neglect, the department shall waive the penalty." *Id.* (Emphasis and alteration added).

Title 45 IAC § 15-11-2(b) (2004) states:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's *carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence.* Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

*Id.* (Emphasis added.) The next subsection of the regulation sets out the standard of care a taxpayer must prove pursuant to IC § 6-8.1-10-2.1(e) to establish reasonable cause for failing to meet its tax compliance duties to the Department. Subsection (c) of 45 IAC § 15-11-2 reads in relevant part as follows:

> (c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 [sic][should read IC 6-8.1-10-2 (repealed and re-enacted in 1991 as IC 6-8.1-10-2.1)] if the taxpayer affirmatively establishes that the failure to…pay a deficiency was due to reasonable cause and not due to negligence. *In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. …*
>
> …

> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

*Id.* (Emphasis and alterations added.)

Under IC § 6-8.1-5-1(b) (2004) and 45 IAC § 15-5-3(b)(8) (2004), the person against whom a proposed assessment is made has the burden of proving that it is wrong. That burden applies to abatement of penalty assessments, as well as substantive tax assessments. *"A person who wishes to avoid the penalty imposed under [IC § 6-8.1-10-2.1(a) and (b)] must make an affirmative showing of all facts alleged as a reasonable cause* for the person's failure to file the return, pay the amount of tax shown on the person's return, pay the deficiency, or timely remit tax held in trust[.]" IC § 6-8.1-10-2.1(e) (emphasis and alterations added). The burden of proof is not on the Department to show negligence.

The General Assembly copied the phrase "due to reasonable cause and not due to willful neglect" into former IC § 6-8.1-10-2(d) (Supp. 1980), the predecessor of current IC § 6-8.1-10-2.1(d), *verbatim* from I.R.C. (26 U.S.C.) §§ 6651(a) and 6656(a) (1976) (current respective versions at *id.* (2000)). Both federal statutes use the phrase "unless it is shown that such failure is *due to reasonable cause and not due to willful neglect*" (emphasis added) as the condition and standard of care under which the Internal Revenue Service ("I.R.S.") may not make the addition to tax. I.R.C. § 6651(a)(1)—(3) respectively require such an addition if a taxpayer fails to file a return by the due date, to pay less than all of the amount shown on a return, or to pay a deficiency upon notice and demand by the I.R.S. I.R.C. § 6656(a) requires an addition to tax if a taxpayer deposits less than the full amount of a trust fund tax payment.

In *United States v. Boyle*, 469 U.S. 241 (1985), the Court said (among other things) that "[t]o escape the penalty, the taxpayer bears the heavy burden of proving both (1) that the failure did not result from 'willful neglect,' and (2) that the failure was 'due to 'reasonable cause.' 26 U.S.C. [I.R.C.] § 6651(a)(1)." *Id.* at 245 (alteration added). Six years later, in 1991, the General Assembly repeated the phrase "due to reasonable cause and not due to willful neglect" unchanged in current IC § 6-8.1-10-2.1(d). When an Indiana statute "virtually mirror[s]" the language of a federal law and is enacted after the United States Supreme Court has construed the federal statute, "[t]hese factors make [a dispute arising under the same interpreted language, copied into the Indiana statute,] a strong case for presuming that the Indiana legislature intended to adopt the federal construction in [that Court's opinion]." *Brownsburg Area Patrons Affecting Change v. Baldwin*, 943 F. Supp. 975, 988 (S. D. Ind. 1996)(alterations added), *quoted with approval in* 714 N.E.2d 135, 140 (Ind. 1999), *answering question certified by* 137 F.3d 503, 510 (7th Cir. 1998), *aff'd* 1999 U.S. App. LEXIS 23325 (7th Cir. Sept. 17, 1999). The presumption of adopted construction also applies when the General Assembly re-enacts any statute, regardless of its legislative source, in the same or substantially the same language after the court of last resort of the originating jurisdiction has construed the source statute. *E.g., State ex rel. Matheny v. Probate Ct. of Marion Co.*, 159 N.E.2d 128, 131 (Ind. 1959). Thus, *Boyle*'s interpretation of the phrase "due to reasonable cause and not due to willful neglect" is binding on the Department. A taxpayer protesting a proposed negligence penalty to the Department therefore must prove not just the absence of willful neglect (as the present taxpayer's argument implies), but also that reasonable cause to waive the negligence penalty exists.

The present taxpayer's generalized allegation that it has a use tax accrual system is not "reasonable cause" for waiving and refunding the negligence penalties. First of all, the taxpayer has made no factual showing of any kind, let alone one that would constitute "reasonable cause," that the alleged system exists, or existed during the audit period, let alone that it used that system in connection with the assessed purchases. However, the Department would not have waived the negligence penalties based solely on evidence that the taxpayer had a procedure in place during the audit period to discharge its tax compliance duties, even had it submitted such evidence. *See Ind. Sugars, Inc. v. State Bd. of Tax Comm'rs*, 683 N.E.2d 1383, 1386 (Ind. Tax Ct. 1997) (holding evidence of such a procedure to be insufficient to show that the procedure was followed in a particular instance), following *F & F Constr. Co. v. Royal Globe Ins. Co.* 423 N.E.2d 654, 656 (Ind. Ct. App. 1981).

There is thus no evidence in the record before the Department to indicate that the taxpayer exercised the "ordinary business care and prudence" that 45 IAC § 15-11-2(c) requires, i.e. that it was not negligent as defined in 45 IAC § 15-11-2(b). Indiana law is settled that this state's taxation hearing officers, and by extension the state-level taxing authorities of which they are agents, "do not have the duty to make a taxpayer's case." *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018, 1024 (Ind. Tax Ct. 1999), *cited with approval in State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257, 1264 (Ind. 2002). The Tax Court stated its rationale for this rule in *Hoogenboom-Nofziger* as follows:

> [T]o allow [a taxpayer] to prevail after it made such a cursory showing at the administrative level would result in a tremendous workload increase for [the Department and] the State Board [now the Indiana Board of Tax Review], … administrative agenc[ies] that already bear[ ] … difficult burden[s] in administering this State's [listed and] property tax system[s]. If taxpayers could make a de minimis showing and then force [the Department or] the State Board to support its decisions with detailed factual findings, the [Indiana taxing authorities] would be overwhelmed with cases such as this one. This would be patently unfair to other taxpayers who do make detailed presentations to the [taxing authorities] because resolution of their appeals would necessarily be delayed.

715 N.E.2d at 1024-25 (alterations added).

However, if the taxpayer had submitted evidence it installed the alleged system after, rather than before, the audit period (as its use of the word "has" in its protest letters may imply), such evidence would have been proof of what lawyers call "subsequent remedial measures." Any such evidence would have been irrelevant to whether the taxpayer was negligent during the audit period in failing, or had reasonable cause for its failures, to remit use tax on its purchases. Any implementation of such safeguards, if true, would have occurred after the audit period ended. Thus as a matter of causation (or, more accurately, lack of causation), its alleged creation of those procedures could not have had any mitigating effect on the taxpayer's negligence during that period. In addition to the absence of evidence and lack of relevance of any subsequent remedial measures, the Department also notes that in any original tax appeal, it would not be able to introduce evidence of such controls as proof that the taxpayer was negligent during the audit period. *See* IND. R. EVID. 407 (making evidence of subsequent remedial measures inadmissible

to prove negligence or culpable conduct in connection with an event). It is therefore only fair that, at the administrative level, the Department should decline to consider the taxpayer's requesting relief from the proposed negligence penalties for any such after-the-fact reasons.

## FINDING

The taxpayer's protest and claim for refund are denied as to this issue.

## II. Tax Administration—Order of Conducting Refund Claim Investigations and Audits

## DISCUSSION

### A. TAXPAYER'S ARGUMENT

The taxpayer also says that the Department could have offset them against the taxpayer's original refund had Audit Division conducted the investigation and the audit together.

### B. ANALYSIS

Strictly speaking, the Department does not have to address this issue, as the Analysis of Issue I completely resolves this protest. Nevertheless, a few observations are in order.

IC § 6-8.1-3-1(a) states that "[t]he department [of state revenue] has the primary responsibility for the administration, collection, and enforcement of the listed taxes. *In carrying out that responsibility, the department may exercise all the powers conferred on it under this article in respect to any of those taxes.*" *Id.* (Emphasis and alterations added.) IC § 6-8.1-3-12(a) states in relevant part that "[t]he department may audit any returns filed in respect to the listed taxes, … and may investigate any matters relating to the listed taxes." *Id.* Regarding the Audit Division in particular, IC § 6-8.1-4-1(b) states in relevant part that the Audit Division "shall: … (2) annually audit a statistical sampling of the returns filed for the listed taxes that are not administered by the [former] special tax division [now the Fuel & Environmental Tax Division]; … [and] (5) conduct audits requested by the commissioner or the commissioner's designee." *Id.* (Alterations added.)

None of the foregoing statutes restrict the discretion of either the Department in general or the Audit Division in particular as to whether they are required to conduct an investigation and an audit for the same tax period/s together or separately. Neither do any of those statutes specify any order in which the two procedures are to be conducted.

The only statute that can restrict the Department's and the Audit Division's ability to conduct an audit is IC § 6-8.1-5-2(a), which sets out the periods of limitations within which the Department must issue a proposed assessment. IC § 6-8.1-5-2(a)(2) in particular states that "in the case of a return filed for gross retail or use tax," among other taxes, the proposed assessment must be issued within three years of "the end of the calendar year which contains the taxable period for which the return is filed." *Id.* IC § 6-8.1-9-1(a) sets the same deadline for the filing of a claim for refund for the same taxes listed in IC § 6-8.1-5-2(a)(2).

As set out in the Statement of Facts, the taxpayer filed its first claim for refund on December 31, 2002, the last day under IC § 6-8.1-9-1(a) for which it could file a claim that included calendar year 1999. The assessment period of limitations for that year expired at midnight that day by operation of IC § 6-8.1-5-2(a)(2). In addition, the Department's records indicate that the audit was not actually assigned to a field auditor until January 2004, by which time the assessment period of limitations for calendar year 2000 had also expired. It is not clear from the Department's records why the audit assignment was delayed. Thus, by the time the auditor was actually in the field, calendar years 2001 and 2002 were the only ones still open to assessment. (However, the Audit Division retained the ability to examine calendar years 1999 and 2000 by operation of 45 IAC § 15-9-2(c) "to determine that the reasons set forth by the taxpayer for the refund [as to years closed to assessment] are valid." *Id.* (Alteration added.))

Whatever the reasons were for the delays in filing the first claim for refund and beginning the audit, however, they do not change the Audit Division's statutory discretion to conduct audits and investigations for a tax period in combination, separately, or in whichever order it sees fit.

## FINDING

The taxpayer's protest and claim for refund are denied.

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